No. 12073

In the United States Court of Appeals for the Ninth Circuit

J. W. MALONEY, UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF OREGON, APPELLANT

v.

ROSS B. HAMMOND, APPELLEE

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF OREGON

PETITION BY THE APPELLANT FOR REHEARING

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Assistant Attorney General.

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To the Honorable the Judges of the United States Court of Appeals for the Ninth Circuit:

J. W. Maloney, Collector of Internal Revenue for the District of Oregon, petitions for a rehearing in the above entitled case for the following reason:

In the opinion filed September 7, 1949, the Court failed to decide on the merits the second question presented, namely, whether the amounts of $86,635.88 in 1942 and $77,366.37 in 1943, accrued by taxpayer to the accounts of Mason and Peterson under their profit sharing agreements, are allowable deductions in those years. The District Court decided this question on the merits, holding that the deductions were properly taken

by the taxpayer in 1942 and 1943 and are allowable (R. 33, 35, 38-39) and one of the points on appeal specifically relates to this holding (R. 48-49).

In the last two paragraphs of its opinion this Court held that it could not find an abuse of discretion in the denial by the District Court of the Collector's motion to amend his answer to plead as a set-off to the refund claimed the tax which results from disallowance of the Mason and Peterson deductions referred to above, since the amended answer does not appear in the record. Apparently, therefore, this Court took the view that the question as to the allowability of the deductions for profits accrued to Mason and Peterson was not raised by a pleading of the Collector and was thus not properly before it.

It is, however, submitted that the issue is present in the case even though it was not asserted by the Collector's answer or by amended answer. This is a suit by the taxpayer for a refund of taxes paid for 1942-1943 and he is not entitled to a judgment unless he has in fact overpaid his taxes for those years. To the extent of the deductions in respect of amounts accrued to Mason and Peterson, if erroneously taken in those years, he underpaid his taxes and the resulting underpayment must be subtracted from the tax which was paid in order to arrive at the amount overpaid for which judgment may be given. This is true even though the statute of limitations would bar the Commissioner of Internal Revenue from assessing and collecting an additional tax for the years in suit. These principles are fully established by *Lewis* v. *Reynolds,* 284 U.S. 281, 599.[1] Thus, the question of whether the deductions were

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[1] The cases of *McEachern* v. *Rose,* 302 U.S. 56, and *Rothensies* v. *Electric Battery Co.,* 329 U.S. 296, as well as other cases on which the taxpayer relied (Br. 73-77), involved different questions and do not affect the authority of *Lewis* v. *Reynolds, supra.* In the *McEachern* case it was held that a tax liability for one year, assess-

properly taken in 1942 and 1943 by the taxpayer was an essential element in determining the taxpayer's right to a refund of taxes paid for 1942-1943 and the amount thereof, and since this is so, there was no necessity that the question be affirmatively pleaded by the Collector. Similarly, since an essential element of taxpayer's case was to establish that the deductions were properly taken in order to establish his right to a refund in this suit against the Collector, the United States was not a necessary party to the suit. Cf. *Lewis* v. *Reynolds, supra,* where the United States was not joined as a defendant with the Collector.[2] Indeed, in this posture the principal reason for filing an amended answer in this case would be to advise the taxpayer of the Government's position that the amount of profits accrued by taxpayer to the accounts of Mason and Peterson were not properly deductible. But this purpose was served even though the amended answer was not actually filed. The taxpayer's objections to the motion for leave to file an amended answer state (R. 8) that the amended answer was tendered with the motion and the taxpayer was thus

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ment of which was barred by the statute of limitations, could not reduce overpayments of taxes for other years, refund of which was sought in the suit. The *Electric Battery* case held that a barred claim for refund of excise taxes for one period could not be recouped against an income tax owing for the year 1935. These decisions of course recognize the basic premise that taxes for different years and different kinds of taxes are different causes of action. But the present case, like *Lewis* v. *Reynolds, supra,* does not involve an attempt to setoff a tax for one year against a refund of tax for another year. On the contrary it involves a suit for refund of income taxes paid for 1942-1943 and the question is whether the tax for those years has been overpaid. If erroneous deductions were taken in those years, there has been no overpayment to that extent.

[2] The statement in the affidavit of Thomas R. Winter in support of the motion for leave to file an amended answer (R. 7-8) that the United States was a necessary party to the suit was made because the Government was then endeavoring to assert a counterclaim for an affirmative judgment of $6,554.03 against the taxpayer to which the United States would have been a necessary party. See Finding 26 (R. 36-37).

on notice of the Government's position. In any case, evidence on the merits on this question was offered and received at the trial and, as stated, the District Court decided the question on the merits. The Collector's statement of points on appeal (R. 48-49) asserts error both as to the holding on the merits that the deductions were allowable and as to the denial of the motion to amend. Thus, the question on the merits is properly before this Court and must be decided, even though the Court decided in the opinion of September 7, 1949, that the District Court did not abuse its discretion in denying the motion to file and amended answer.

It is therefore respectfully requested that this Court grant a rehearing and decide the issue as to the propriety of the deductions. As the Collector's brief shows (pp. 24-26), the amounts credited to Mason and Peterson on taxpayer's books in 1942 and 1943 were not properly accruable as deductions because the taxpayer was not unconditionally obligated to pay the amounts in those years. Second, even if it is assumed *arguendo* that the amounts were properly accruable, Section 23 (p) (1) (D) of the Internal Revenue Code nevertheless bars the right to deduct the accrued items until the year or years in which the amounts were actually paid. (See Br. 26-27.) It is clear that the facts of this case fall precisely within the terms of Section 23 (p) (1) (D). See Section 29.23 (p)-1 of Treasury Regulations 111 (Appendix, *infra*). Taxpayer relies on the part of the regulation which states that the provision is not intended to cover the case where payment of compensation is deferred until after the year of accrual merely because of inability of the employer to pay the compensation in the year of accrual. There is no showing here, however, that the taxpayer was unable to pay the accrued compensation to Mason and Peterson in 1942 and 1943. Although

the agreements with Mason and Peterson provided that taxpayer might retain their shares of the profits in excess of their drawings as working capital, this provision at best simply relieved taxpayer of the necessity in the future of securing working capital in the amounts to be accrued from other sources. There is no indication that taxpayer could not have obtained working capital of $86,635.88 at the end of 1942 and $77,366.37 at the end of 1943 in some other manner and thus the inference is compelled that the retention of these amounts of compensation in the taxable years was simply a convenience to him, rather than a financial necessity.

The Court should hold that the deductions of $86,635.88 in 1942 and $77,366.37 in 1943 are not allowable.

While we are of the firm conviction, for the reasons heretofore given, that the filing of the amended answer was unnecessary to raise the issue as to the propriety of the deductions here in question on the merits, nevertheless if the Court feels that the amended answer is necessary or desirable to a consideration of the question on the merits, it is requested that the Court direct the District Court to certify the proposed amended answer, which was attached to and tendered with the motion for leave to file. (R. 8, 11, 18-19.) This is clearly within the Court's power under Rule 75(h), Federal Rules of Civil Procedure. The request to supplement the record is proper and should be granted even though the Court's opinion and judgment have already been rendered. Cf. *American Chemical Paint Co.* v. *Dow Chemical Co.,* 164 F. 2d 208 (C.A. 6th). Upon receipt of the amended answer, the Court will see that it asserted as a defense to the taxpayer's claim for refund that taxpayer had not overpaid his taxes for 1942-1943, since he erroneously deducted the

amounts of $86,635.88 in 1942 and $77,366.37 in 1943, and that the District Court abused its discretion in not granting leave to file it, in order that the Government's position might be set forth in the pleadings.

Respectfully submitted,

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HENRY L. HESS,
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VICTOR E. HARR,
Assistant United States Attorney.
SEPTEMBER, 1949.

CERTIFICATE OF COUNSEL

The appellant herein, by its attorneys, hereby certifies that the foregoing motion is not presented for the purpose of delay or vexation, but is, in the opinion of counsel, well founded and proper to be filed herein.

THERON LAMAR CAUDLE,
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SEPTEMBER, 1949.

APPENDIX

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.23(p)-1. *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred Payment Plan—In General.*—Section 23 (p) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. * * * Section 23 (p), however, is applicable to all contributions under a stock bonus, pension, profit-sharing, or annuity plan, whether or not the employees' rights in such contributions are nonforfeitable.

A contribution to be deductible under section 23 (p) must be an ordinary and necessary expense which would be deductible under section 23 (a) if it were not for the fact that the statute specifically provides that it shall be deductible under section 23 (p). A contribution by a corporation under a plan which is created primarily for the purpose of benefiting shareholders of the company is not deductible. Such contribution may constitute a dividend within the meaning of section 115 (a). A contribution under a plan that is set up for the exclusive benefit of employees as such, and thus represents an item of expense, is of the nature of compensation for personal services rendered by the employees covered by the plan. The amount of contributions allowable as a deduction has an over-all limitation—the entire contributions for the taxable year when added to other compensation paid must represent reasonable compensation for services rendered by the employee beneficiaries. * * * In the case of a stock bonus or profit-sharing plan which provides for additional compensation for employees not paid as a pension, a contribution

will not be fully deductible unless it can be justified as a reasonable addition to the compensation otherwise paid to employees who are beneficiaries under the plan. In addition to the over-all limitation referred to above, section 23 (p) sets forth further limitations as to the amounts that may be deductible for the taxable year.

Section 23 (p) is not confined to formal stock bonus, pension, profit-sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. * * * If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

Deductions under section 23 (p) are generally allowable only for the year for which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his return on the accrual basis. * * *

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